

LEGAL NEWS

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WHY INCORPORATE?

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If you simply start doing business as an individual, the business is a sole proprietorship. If more than one person does business together, the business is a partnership. While it is often advisable (especially with a partnership) to do some planning and draft legal agreements, the law does not require them for either of these forms of business. In order to start a corporation, on the other hand, you must draft certain legal documents, file some of them with the secretary of state (with the appropriate filing fee, of course) and maintain legal records. Given the trouble, why do so many businesses choose to do business as corporations?

The primary advantage is the concept of limited liability. When you are in business as a sole proprietor, your personal assets are at risk for the debts of the business. Your house, your car, and your personal savings can all be reached to pay the business debts or to satisfy lawsuits against the business. With a corporation, normally only the corporation's assets can be taken. Your personal assets which are not part of the business are then safe.

There are some limits to this. First, because lenders recognize the limited liability rule, they will often demand a personal guarantee from the owners of a small corporation before they will lend money. This effectively makes you personally liable on the debt, as well as the business. Second, under some unusual circumstances a court can ignore the corporate form and make the owners personally liable. Your attorney can advise you how to avoid this problem.

Corporations also exist separate from the people who formed them. When a sole proprietor dies, the sole proprietorship dies with him. A corporation remains in existence, which means that the ownership interest can be transferred to another person while the business continues in existence. Of course, this also means that, when there is more than one owner, it is a good idea to plan for what will happen when one of the owners dies.

There are some disadvantages to the corporate form. There is the cost of forming the corporation. A corporation must also keep written records of many of its actions on a regular basis. Whether the corporation makes or loses money, it must pay a minimum franchise tax to the State.

An ordinary corporation (sometimes called a "C" corporation, after the relevant section of the tax code) is treated as a separate entity for tax purposes. In other words, when the corporation makes money it is subject to income tax; when the money is later distributed to the shareholders, they are reportable as dividends and taxable again. This "double taxation" can, in many cases, be avoided if you elect "S" corporation status. Your attorney and accountant can aid you in determining whether your corporation is eligible for "S" status and in electing it if you choose.

Visit the Law Office of Nancy A. Chillag on the web at www.chillag.com. Ms. Chillag is an associate member of NTMA.